> schedules have been forced upon it (as well as the other Bell companies) by state regulators and the Federal Communications Commission.[32]

As a result, the accounting earnings included in both the Commission's ARMIS reports and the Form 492 Interstate Earnings Reports (which is used to ensure compliance with the current price cap earnings regulation) present an artificially inflated estimate of the return on investment actually experienced by the price cap LECs.

For example, in order to compare the earnings of the price cap LECs with the earnings of AT&T, it is instructive to determine the effect on reported earnings of the differing regulated depreciation rates prescribed for the price cap LECs versus those used by AT&T. AT&T's composite depreciation rate is approximately 10 percent whereas the prescribed composite rate for the price cap LECs is approximately 7 percent. This difference in regulated accounting results in a difference of approximately 350 basis points in measured rate of return on investment. Such distortions caused by differing regulated accounting requirements must be adjusted to make meaningful comparisons.[33] Thus, when the earnings of the price cap LECs are placed on a regulated depreciation rates basis equal to that of AT&T, the price cap LECs' reported returns on investment would be over 350 basis points below the levels currently reported.

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[32] "Honesty Isn't Such a Bad Policy," Riva Atlas, Forbes, July 4, 1994, (Atlas in Forbes) p. 118.

[33] Under price cap regulation, increases in regulated depreciation rates decrease accounting earnings because depreciation rate changes have been ruled endogenous (do not affect price caps).

Table 3
Estimate of Price Cap LEC Earnings Restated
For Competitive Depreciation Rates

1991-93	8.5 to 9.0%

Given the magnitude of this depreciation rate effect on reported earnings, it would be totally inconsistent for the Commission to conclude that AT&T's achieved interstate earnings of approximately 13.22 percent over the 1991-93 time period was reasonable and at the same time conclude that the price cap LECs' reported accounting earnings results of 12.34 percent (which, when restated on a comparable basis were approximately 8.5 percent to 9.0 percent) were unreasonably high.

B. The LECs' Fourth Quarter Behavior Is No Different Than Companies Like MCI.

MCI asserts that "booking large expenses in the fourth quarter seems to be an attempt" by LECs "to manipulate the sharing rules" and requests that the Commission "fashion a remedy to curtail the LECs' inclination to overstate their fourth quarter expenses."[34] MCI contends that LECs are incurring and/or booking higher fourth quarter expenses in order to achieve a targeted earnings level and cites early retirement programs as an example of the type of year-end expense being incurred.[35]

MCI suggests that the LECs should not follow generally accepted accounting principles (GAAP), which determine the nature and timing of the reporting of costs. MCI itself has recorded significant fourth quarter expenses which it undoubtedly would defend as

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[34] MCI, p. 33.

[35] MCI also expresses skepticism that expenses for these programs actually result in cost savings. There is no doubt that savings from these programs are being realized.

appropriate. Accounting principles may compel that such expenses be recorded as they are incurred.

Price cap LECs do not incur costs for the purpose of lowering sharing amounts. Interstate access represents approximately 25 percent of the LECs' business. Force reductions, regulated depreciation rate changes, and FASB accounting changes, each of which may affect year-end earnings, also affect both interstate and intrastate results and may affect company results as reported to outside shareholders as well. The company is responsible to all of its stakeholders and must make prudent business decisions that will benefit the entire company.

In addition, company books and records are audited annually by independent external auditors and all booked expenses must meet GAAP accounting standards. LECs cannot arbitrarily book expenses in order to manipulate their financial results. In order to book any expense, no matter how large or small, GAAP accounting requires that the expense be known and measurable and booked in the proper accounting period.

MCI suggests that one-time accounting adjustments for the fourth quarter be declared by September 15 of each year and, further, that customers and other parties be allowed to comment or suggest alternative accounting methods. The LECs' competitors and customers should not be allowed to dictate accounting principles applicable to the LECs. SWBT strongly emphasizes that a fourth quarter expense is not less valid than a first, second or third quarter expense. It is curious that, on one hand, MCI urges the Commission to eliminate the "other" category of exogenous costs under the guise of <u>minimizing</u> administrative burden but, in this case, proposes to create a significant administrative backlog and havoc. LEC management, not the LECs' customers or competitors, are in the best position to administer LEC compliance with accounting standards and regulations.

C. Sharing Should Be Eliminated, Not Increased. (Baseline Issues 4a, 4b)

The price cap plan has been an important and somewhat successful first step toward more flexible regulatory oversight. The Commission should adopt a pure price cap system by eliminating the sharing and lower formula adjustment mark (LFAM) mechanisms and deprecation prescriptions,[36] thereby removing the last remnants of ROR regulation.[37] However, in attempts to use the regulatory process to inappropriately reduce prices and hamper the ability of the price cap LECs to compete, the LECs' customers and competitors recommend further tightening earnings sharing.[38]

SWBT, USTA and a number of the price cap LECs demonstrated that earnings sharing must be eliminated.[39] To retain earnings sharing is to reimpose the inefficiencies of cost-based rate base regulation that the Commission concluded were inappropriate in the AT&T plan and in its Cable TV rate regulation. Earnings sharing and its resulting inefficiencies are not imposed on the other carriers that are the LECs competitors.

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[36] American Telephone and Telegraph Company Petition for Waiver of the Commission's Depreciation Methods and Procedures, AAD 93-18, Order (DA 94-540) (released May 31, 1994). (eliminated regulation of depreciation rates for AT&T, which is under a pure price cap plan).

[37] See, e.g., SWBT, pp. 43-47; USTA, pp. 45-52; USTA, Attachment 2, Robert G. Harris (Harris), pp. 19-21; Harris Reply, Attachment, p. 26.

[38] Ad Hoc, p. 24; ICA, p. 14;

[39] SWBT, pp. 43-47; USTA, pp. 45-52.

Other parties agree that sharing should be eliminated. CCIA concluded that the Commission's system of regulation is "compromised to a considerable degree by the 'sharing' mechanism."[40] CCIA states further that "this limitation on the extent to which LECs can benefit from efficiency improvements lessens the efficiency incentive the Commission created."[41] CSE believes that elimination of the sharing and low-end adjustment mechanisms would mirror the efficiency incentives found in competitive markets and ensure that the LECs compete in the capital markets on an even footing with unregulated firms.[42]

The LEC Price Cap Order stated that sharing was indicated for the LECs, but not for AT&T, due to the lack of competition in LEC markets.[43] As shown by SWBT's Comments, and these Reply Comments, the state of competition has markedly changed.[44] Thus, the sharing requirement should be eliminated, not increased.

D. ROR Represcription Does Not Apply To Price Cap Regulation. (Baseline Issue 3a)

Consideration of any adjustments to the ROR calculations on which the original price cap plan was based should not be made in this proceeding. Such considerations are inappropriate here. In the LEC Price Cap Order, the appropriate scope of the review to be undertaken here was described:

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[40] CCIA, p. 7.

[41] Id.

[42] CSE, p. 7.

[43] LEC Price Cap Order at para. 405 and fn. 583.

[44] SWBT, Appendix COMP; Section II infra.

> The performance review should provide sufficient information to allow the Commission to reevaluate the need for lower end adjustment and sharing mechanisms, and to adjust the sharing mechanism productivity factor if necessary. At that time we will evaluate all aspects of the price cap plan and of LEC performance. Our objective will be to ensure that we are providing strong incentives to carriers to provide a rich variety of services, and a substantial benefit to customers.[45]

While the Commission noted that the sharing mechanism and productivity factor could be adjusted, it did not allow for a "one-time reduction in rates" as questioned in paragraph 45 of the NPRM. Such a retroactive one-time reduction, or any change to the sharing mechanism or productivity factor based on the relative earnings and effective rates of return of the price cap LECs would amount to a represcription. The Commission has noted in numerous proceedings that it has "removed" price cap LECs' interstate services from ROR return regulation, and by implication, any accompanying represcriptions.[46] The Commission has explicitly stated that any ROR represcriptions are not cause to adjust the price cap sharing ranges.[47]

Notwithstanding the above, any represcription would require that all parties be notified to submit the types of evidence listed in Part 65 of the Commission's Rules. Clearly, the NPRM did not ask for parties to submit that type of evidence in this proceeding. To be sure, parties will have submitted evidence in this proceeding that discusses earnings of the price

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[45] LEC Price Cap Order, para. 394.

[46] Amendment of Parts 65 and 69 of the Commission's Rules to Reform the Interstate Rate of Return Represcription and Enforcement Processes, 7 FCC Rcd 4688 (1992), at para. 14.

[47] Id., fn. 92.

cap LECs and compares them to other firms, but a formal represcription proceeding requires much more.[48]

In the 1990 Represcription Order Reconsideration,[49] the Commission determined that "the authorized rate of return will not be considered in determining whether overall earnings under price cap regulation are lawful."[50] Those parties that compare the authorized ROR at the outset of price cap regulation (11.25%) to LEC earnings, and request changes to the productivity factor or a one-time adjustment to LEC rates are attempting to achieve something "through the back door" that was not permitted throughout price cap regulation. The Commission should reject any such attempts.

1. The Review Of The AT&T Price Cap Plan Did Not Include Attempts To Impose ROR Regulation Concepts.

During the review of the AT&T price cap plan, the Commission did not request, nor did AT&T offer, any adjustments to the AT&T price cap plan based on cost of capital or interest rates. AT&T, in this proceeding, contradicts the recommendations it made for itself, by recommending ROR regulation concepts in a price cap regulation regime. The Commission should not adopt AT&T's recommendation; in fact, the approach adopted in the AT&T price cap proceedings provide appropriate grounds for rejecting the use of cost-based cost of capital concepts in the incentive regulation plan applicable to the LECs.

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[48] 47 CFR Part 65. Moreover, Part 65 rules are admittedly flawed and in need of significant modernization.

[49] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 6 FCC Rcd 7193 (1991) (1990 Represcription Order Reconsideration).

[50] 1990 Represcription Order Reconsideration, para. 63.

2. The Cost of Capital Evidence Presented Does Not Justify Earnings-Based Adjustments To The LEC Price Cap Plan.

AT&T asserts in its comments that an ROR represcription would have been triggered in March 1993, based on the "LECs' own comments filed with the Commission in other proceedings."[51] This is a complete misrepresentation of USTA's filing in that proceeding.[52] AT&T's conclusion is based on their own myopic view of a change in interest rates and how such a change should apply only to a selected subset of regulated carriers. Specifically, AT&T contends that "numerous LECs supported an automatic trigger for the rate of return represcription process if the six-month moving average of Aa utility bond yields changed by more than 150 basis points from the value existing prior to the previous represcription."[53]

In fact, the LECs, in their USTA filing, stated that "(t)he initial base rate to be used for comparison with the six-month rolling average should be set at the time of the order in this proceeding. This would eliminate any possible bias of the trigger as a result of the selection of some known historical point."[54] Obviously, the LECs' concern over the "gaming" of the process was well founded. AT&T is now attempting to game a possible starting point.

GSA tries to skirt the regulations governing a ROR represcription by turning a strict ROR calculation of purported overearnings into an adjustment to the productivity offset

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[51] AT&T, p.32, fn. 44.

[52] USTA Comments, in CC Docket No. 92-133, filed September 11, 1992 (USTA 1988). pp. 31-39.

[53] AT&T, p. 32, fn. 44, emphasis added.

[54] USTA 1988, p. 36.

for price cap LECs. GSA computes "excess" earnings (defined by GSA as any earnings over an ROR of 11.25%) and recommends capturing them by raising the productivity index.[55] This assumption attempts to circumvent the rules governing ROR represcriptions and, at the same time, does not represent a real analysis of productivity.

ETI, in its analysis for Ad Hoc, wrongly claims that investment and efficiency incentives are unaffected by the possibility of future rate reductions:

> [a] price cap LEC does not lose its incentive to innovate, to improve efficiency, or to develop new markets for its services merely because, at the end of a three-year period, it may be required in the future to 'give up' certain of these gains through, for example, an upward adjustment in its X factor.[56]

A LEC, or any company for that matter, is not faced with an absolute, all-or-nothing situation where its business incentives either exist or do not exist. There are many degrees of incentive and ETI clouds the issue by not recognizing that these incentives are reduced by the potential for future givebacks and that this reduction may be enough for the investment to be avoided in its entirety and the benefits totally unrealized.

Investment decisions rely heavily on discounted cash flow analyses that compare expected cash "in-flows" with expected cash "outlays" over time to arrive at an expected net present value and return on investment. A key consideration in these analyses is an assessment of whether the expected cash "in-flows" are temporary or will be affected in the future by regulation (for example, will be reduced by earnings sharing or other regulatory effects). Thus, all firms faced with earnings sharing or the prospects of reduced cash flows due to regulation,

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[55] GSA, pp. 9-10.

[56] Ad Hoc, Attachment A, (ETI Paper) p. 107.

have lower expected returns on any given investment. These reduced cash flows depress the expected returns on investment to points where certain investments will no longer be pursued. Thus, ETI is wrong that the possibility of future rate reductions does not affect investment.

Ad Hoc contends in its comments that "in the three years since the onset of FCC price cap regulation, net BOC investment was only $564-million, whereas some $11-billion was placed in non-BOC ventures."[57] This is a classic case of deception with statistics. Ad Hoc deliberately misleads the Commission by comparing investment net of depreciation investment for the BOCs with gross investment for the non-BOC operations. These same data were misused by the Consumer Federation of America in its report, "Milking the Monopoly: Excess Earnings and Diversification of the Baby Bells Since Divestiture," and were also cited by ARINC.[58] The facts show that the parties are blatantly wrong. The Regional Bell Holding Companies have made significant investments in their regulated operations in recent years. From 1991 to 1993, BOC gross investment totaled $42.8 billion, whereas non-BOC investment by the respective parent companies was only $8.0 billion. Thus, Ad Hoc's contention that "the BOC subsidiaries accounted for only about 5% of new capital investment"[59] is completely erroneous.

Examination of total interstate earned returns of the price cap LECs over 1991-93 indicates that the achieved results comport with Commission intent as enunciated in the 1990 represcription. The Commission stated:

> that the cost of equity for interstate access should still be well below the median for the S&P 400, above the midpoint of the

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[57] Ad Hoc, Attachment A, p. 68, [emphasis omitted].

[58] ARINC, pp. 3-4.

[59] Ad Hoc, Attachment A, p. 69.

> lowest quartile of the S&P 400, and at or below the midpoint of the second quartile.[60]

On an earned return basis, the LECs' returns (12.34%) were indeed well below the median for the S&P 400 (14.92%), and above the midpoint for the lowest quartile of the S&P 400 (6.25%) and at or below the midpoint of the second quartile (12.90%). Thus, even before recognition of the artificial inflation of earnings caused by low regulated depreciation rates, concerns about excess earnings during the price cap regime should be allayed when the earned returns are viewed in the context of the Commission's stated guidelines.[61]

E. The Productivity Factor Should Be Reduced. (Baseline Issues 3a, 3b, 3c, 4a, 4b)

1. Competitors Would Reimpose ROR Regulation On The Price Cap LECs.

The LECs' major competitors and large customers (CAPs, IXCs, cable TV) consistently urge the Commission (1) to increase the productivity offset (as high as 5.97%) because LEC earnings exceeded the 11.25% target for ROR LECs; (2) to require substantial one-time reductions in price cap indexes (in the amount of $322 million according to AT&T; by 7.5% according to MCI); and (3) to adopt an alleged lower cost of capital (below 10%) and reduce the sharing ranges proportionally to reflect this lower cost of capital.

These parties base their positions on unfounded observations regarding LEC earnings. They generally consider the fact that price cap LEC earnings were slightly above the

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[60] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd 7507 (1990), para. 182.

[61] S&P 400 returns are calculated as Net Income Before Extraordinary Items + Interest Expense divided by Average Invested Capital (Long-Term Debt + Preferred Stock + Minority Interest + Common Equity). These returns are arrayed and market-weighted to determine percentiles. Source: Standard and Poor's "Compustat PC Plus," CD ROM database dated May 31, 1994.

11.25% mark as "proof positive" that the current productivity offset is set too low, and use this as the basis for a number of proposals that would reimpose greater regulatory restrictions on the LECs. These proposed measures, taken together, are nothing more than a thinly veiled attempt to restrictively impose ROR regulation on the LECs. The Commission should recognize these proposals as such and reject them outright.

These proposals seem to be founded in the misguided notion that the overriding goal of price cap regulation should be to ensure that LEC earnings remain equal to or below the target ROR return established for ROR LECs. For example, MCI states: "the LECs have prospered, achieving rates of return well in excess of the 11.25% level at which rates were initialized,"[62] and quantifies LEC shareholder benefits as the amount which:

> represents the difference between the price cap LECs' achieved earnings in 1991, 1992, and 1993, and the amount they would have earned under rate of return regulation with the authorized return set at 11.25%.[63]

The main conclusion MCI draws from this observation is that the LEC productivity offset is too low and should be increased.

MCI suggests a productivity offset of 5.5%.[64] AT&T also recommends 5.5%.[65] Although their justifications are different, their proposed productivity offsets would

[62] MCI, p. 22.

[63] MCI, p. 23, footnote 39.

[64] MCI, p. 1.

[65] AT&T estimates productivity of 5.97% using ARMIS data for a limited number of the price cap LECs and then subtracts 0.5% to arrive at a recommended offset of 5.5%. AT&T, p. 26.

effectively recalibrate the LECs' opportunity to earn to the 11.25% mark.[66] For example, the estimated LEC productivity of 5.97% proposed by AT&T is nothing more than a derived number that "would have produced an earnings level of 11.25%"[67] during the price cap period.[68] Adopting these proposals would effectively again tie LEC earnings to a target ROR, as under ROR regulation, recalibrating prices with earnings (by adjusting productivity) after three years. The end result is to reinstall ROR regulation.

The AT&T and MCI proposals would also have the Commission eliminate even the limited and short-lived benefits of the 3-year LEC price cap plan. Both parties assert that one-time PCI reductions are necessary to return to customers the benefits the LECs have enjoyed during the price cap years as a result of a productivity offset that was initially set "too low."[69] For example, MCI claims that the LECs must reduce their PCIs by 7.5% as an "adjustment to historical LEC earnings" that corresponds to "the need to increase the productivity factor on a prospective basis."[70] AT&T also proposes one-time PCI reductions (in the amount of $322

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[66] GSA also proposes an increase in the productivity offset based on a methodology that relates achieved LEC earnings to the 11.25% return. GSA, pp. 8-10.

[67] AT&T, p. 24. Curiously, AT&T would <u>reduce</u> this "productivity" estimate of 5.97% by a LEC "productivity dividend" of 0.5% for "exceeding the Commission's 3.3 percent goal, to encourage LECs to continue to perform efficiently." AT&T, p. 26. It is impossible to rationalize a punitive increase in the productivity offset as having any incentive for efficiency.

[68] MCI justifies a proposed productivity increase to 5.9% as a "correction" of the short term productivity study, which the Commission "relied on" in selecting the current productivity offset, by eliminating the 1984 tariff year data point which, according to MCI, is fatally flawed. MCI asserts that the "outstanding profits enjoyed by the LECs under price caps" substantiate that the current offset is too low. MCI, pp. 21-22.

[69] ICA similarly proposes an initial 3% revenue decrease to compensate customers for the allegedly low productivity offset initially adopted. ICA, pp. 12-13.

[70] MCI, p. 26.

million), but justifies them based on lower cost of capital since the adoption of price cap regulation. According to AT&T, "due to the LECs' lower cost of capital, their reference earnings level should be reduced" to 9.93%.[71] This would not only have the Commission continue to regulate the LECs based on earnings, as under ROR regulation, but at an even lower effective ROR than imposed on the ROR companies.

The AT&T and MCI proposals are blatant attempts to circumvent a more broad cost of capital proceeding to determine the proper role for cost of capital determinations applicable to all regulated telecommunications carriers. Instead, they would have the Commission make such a determination outside the proper proceeding, in the guise of price cap review, and constrain LEC earnings to a lower ROR than is in effect for ROR carriers. Contrary to MCI's bold assertion that the issue of cost of capital determination for ROR carriers has no bearing on price cap carriers' cost of capital and sharing zones, and that these two matters are discrete and should be resolved independently,[72] there simply is no justification for holding price cap LECs to lower returns than the remaining regulated carriers (LECs, IXCs or cable TV providers).

The Commission was quite clear on one point when it adopted the LEC price cap plan. The Commission stated: "carriers that can substantially increase their productivity can earn and retain profits at reasonable levels above those we allow for rate of return carriers."[73]

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[71] AT&T, p. 26 [emphasis added].

[72] MCI, p. 31.

[73] LEC Price Cap Order, para. 22 [emphasis added]. Should any adjustment attempt to refund any earned revenues, it may also violate the "filed rate" doctrine. (See, e.g. Arizona Grocery Co. v. Atchison, Topeka and Santa Fe Railway Co. 284 U.S. 370, 390 (1932) "Where the Commission has . . . declared what is the maximum reasonable rate to be charged by a

The final component in ensuring that the LECs effectively face continued rate of return regulation is AT&T and MCI's proposal to further limit the LECs' ability to increase earnings by tightening the sharing ranges in step with their proposed reduction of the LECs' "reference earnings level," which would result in a 132 basis point reduction to the 12.25% and 16.25% thresholds.[74] At the same time, both parties propose that the Commission eliminate the LFAM as "unnecessarily redundant"[75] or as a "device for relieving LECs of business risk."[76] This one-sided proposal is blatantly self-serving.

Actually, the LECs themselves have proposed elimination of LFAM and are willing to take on the added risks of having to "prove in" needed rate relief through a more burdensome filing requirement, if at the same time, they are also given greater opportunity to increase earnings growth through the elimination of the sharing mechanism. The sharing mechanism severely dampens efficiency incentives because it diminishes the LECs' ability to realize the benefits of productivity improvements. Sharing and the LFAM mechanisms are opposite sides of the same coin, and in the interest of risk/return symmetry, both mechanisms should be eliminated. SWBT vehemently opposes the elimination of the LFAM without the elimination of sharing.

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carrier, it may not at a later time . . . subject a carrier which conformed thereto to the payment of reparation measured by what the Commission now holds it should have decided in the earlier proceeding to be a reasonable rate.")

[74] AT&T, p. 33. MCI proposes that the low end adjustment level should be set at 8.54%, the 50% sharing level should be set at 10.54%, and the 100% sharing level should be set at 14.54%. MCI, p. 30.

[75] MCI, p. 32.

[76] AT&T, p. 37.

The proposals to raise the productivity factor or to eliminate LFAM (without eliminating sharing) are unfounded. No party presented any evidence that the price cap experience resulted in earnings outside the range considered reasonable by the Commission. To the contrary, the price cap experience shows that the plan is largely working as anticipated. The LECs' competitors, however, would use these solid results to dismantle the incentive plan and impose even more restrictive earnings requirements on the price cap LECs than faced by ROR carriers. Surely, neither AT&T nor MCI would be willing to invest their shareholders' monies in a regulatory environment where all efficiencies were recaptured and flowed to retained earnings of their competitors or to customers.

2. <u>All Efficiency Gains Should Not Be Awarded To Customers</u>.

One of the Commission's goals for its price cap form of regulation was to "harness the profit-making incentives common to all businesses."[77] The required "harness" is the ability to retain earnings. In a competitive market, all firms are able to retain the benefits of increased efficiency. Likewise, under a pure price cap plan without an earnings sharing mechanism, AT&T is able to retain 100% of the efficiency gains that result from its own actions.

The methods suggested by AT&T and MCI for the price cap LECs, by contrast, would require that 100% of all efficiency gains be passed on to customers in the form of lower prices and none of the efficiency gains that result from LEC actions be retained by the LECs. Thus, AT&T and MCI recommend that the "harness" become a "sharp bit" that gags any and

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[77] <u>LEC Price Cap Order</u>, para. 2.

all profit incentives from the LEC price cap plan. There is no justification for adopting such one-sided and repressive methods for the LEC price cap plan.

If the Commission is to provide a regulatory framework where carriers have incentives to pursue risky investments in competitive markets, it must refrain from the kind of regulation that punishes desirable behavior. Stockholders and management are not oblivious to threat of punitive regulation. If LECs are to have any encouragement to invest in regulated telecommunications markets, there must be an opportunity to benefit from productive investments, similar to that available to the LECs' competitors.

The increasingly pervasive presence of CAPs in high-volume markets, the self-provisioning capability of the IXCs, the increased use of private networks, the globalization of telecommunications technology and capital markets, and the future threats posed by cable TV and wireless providers, have significantly increased the risk of investing in regulated telecommunications markets.[78] Such increased risks require an opportunity for increased rewards. Increasing the productivity offset would be totally inconsistent with evidence that risk has increased for the LECs.

3. Recapturing Past Productivity Gains Would Severely Dampen Price Cap Incentives.

Increasing the productivity factor or adopting a one-time PCI reduction based solely on the belief that LEC earnings were "too high" during the price cap period, would severely dampen the incentives in the price cap system. It would be a clear signal for the LECs

[78] Indeed, the June 22, 1994 issue of the Wall Street Journal reported that some analysts have downgraded "Baby Bell" stocks due to the increase in competition. Wall Street Journal, Heard on the Street, Leslie Cauley, p. C2, June 22, 1994, (Cauley in WSJ).

that this Commission is not committed to equitable and symmetric application of regulation, and that the LECs should not hold on to any hopes of being able to achieve the levels of returns they need from their regulated interstate operations to attract investment. Like any prudent firm, a LEC would have very little incentive to invest its limited funds in the regulated part of its business under such circumstances, where it has no opportunity to increase earnings beyond the low levels deemed "reasonable" by its large customers and competitors (who also compete with the LECs for investors' dollars).

Frequent reviews, with increases to the productivity factor if LEC earnings exceed an arbitrarily-determined threshold ROR and corresponding PCI reductions that impose the higher productivity offset back over the entire price cap review period, as AT&T, MCI, and others propose, clearly represent a recapture of any benefits a LEC may have been able to achieve under price cap regulation. This would eliminate the efficiency incentives that lie at the core of price cap regulation.

These proposals, effectively, would reduce price cap regulation to nothing more than a convoluted form of ROR regulation and reimpose the very disincentives associated with ROR regulation. MCI tries to gloss over this crucial point: "adjustment to the productivity factor now, however, should not be construed as an attempt to recapture productivity gains that will dampen future LEC cost-cutting efforts."[79] This statement is ludicrous. Regardless of how MCI would like to characterize it, these proposals are aimed at recapturing past productivity gains, and their adoption would inevitably result in reduced present value of LEC investments in regulated operations and reduced returns from cost-cutting efforts.

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[79] MCI, p. 24.

4. Some Parties Incorrectly Presume That Price Cap Regulation Did Not Provide Efficiency Incentives.

The harnessing of profit incentives in the LEC price cap plan was intended to provide incremental incentives for LECs. AT&T, MCI and GSA each utilize incorrectly simplistic analyses of achieved price cap LEC earnings to wrongly conclude that the productivity offset should be increased.[80]

At least GSA recognizes that the earnings of carriers under incentive regulation plans are affected by the incentives to be more efficient. GSA correctly recognizes that increases in earnings can and did result from changes in the manner in which the price cap LECs managed their businesses in response to the profit incentives in the plan.[81] GSA, however, recommends that: "the Commission establish a procedure under which the productivity factor is adjusted by half of the difference between expected and realized productivity at the time of each price cap review."[82] Thus, unlike AT&T and MCI who would have all increased LEC earnings given back to the LECs' customers, GSA on the surface would take away half of the LECs' remaining gains. However, GSA's proposal becomes cost-plus regulation and requires an increasingly larger earnings sharing percentage at each review period.[83] SWBT opposes any

[80] AT&T, pp. 22-26 and Appendix B; MCI, pp. 21-24; GSA, pp. 8-9.

[81] GSA, p. 10.

[82] GSA, p. 10.

[83] GSA's proposal essentially requires price cap carriers to reduce their price cap indexes by the full amount of some baseline estimate of industry productivity plus half of any ability to exceed that target, plus half of any subsequent ability to exceed that revised target, plus half of the further subsequent ability, and so on. The eventual result is that the price cap carrier retains essentially 0% of its achieved efficiency gains -- contrary to unregulated competitors, which retain 100% of their efficiency gains.

such proposal that would make it increasingly more challenging for LECs to achieve adequate earnings growth.

If the profit incentives (though significantly muted by earnings sharing) had not existed, then it is very likely that price cap carriers would not have changed their operations to attempt to achieve the increases in earnings that were actually observed during the review period. Thus, any contention that prices would have been significantly lower had the price cap LECs remained under ROR regulation (as implied by the analyses of AT&T, MCI, GSA and others) fails to account for any changes in behavior by the price cap carriers that the incentive regulation plan sought to encourage. Simply put, contrary to the operation of the current price cap plan for LECs, had carriers been forced from the start to give-up a full 100% of their hard-fought gains in efficiency, they would not have worked so hard for the gains. Some of the efficiency gains actually observed would never have materialized. Costs would have been higher, but earnings would have stayed relatively constant at about 11.25%. Such a result would not have been consistent with the Commission's goals. The earnings analyses of AT&T and MCI are based on an incorrect premise. As a result, any comparison of achieved earnings to 11.25% to measure productivity significantly overstates the "appropriate" productivity offset.

The Commission should recognize that LEC behavior can and did change as a result of the limited extent to which the Commission's plan did provide an ability to harness the profit incentive. Thus, any simple analysis that relies on calculating productivity using observed returns on investment is seriously flawed.

5. There Is No Basis For Increasing The Productivity Factor.

There is no basis for increasing the productivity factor at this time. The evidence presented in this proceeding simply does not support a higher productivity offset. While several parties filed "studies" and "evidence" that allege higher achieved LEC productivity during the price cap period, none of these studies truly measures LEC productivity. The Commission should reject these studies and the proposals for a higher productivity offset.

a. The AT&T Model

The AT&T model derives a PCI formula productivity offset equivalent had the price cap LECs' earnings been constrained to 11.25% over the entire price cap period.[84] This derived number merely represents what the productivity offset would have had to have been if the LECs had been constrained to 11.25% returns during the price cap period. Thus, this study infers a productivity differential from reported accounting earnings data. It says nothing about the relationship between LEC outputs and productive inputs, as a true measure of productivity would.

There are several problems with the AT&T study that invalidate AT&T's results. First, as explained by NERA:

> LEC earnings -- as measured by regulatory accounting rules -- are notoriously poor proxies for economic profit. . . In particular, the accounting treatment of depreciation for regulated LECs is based on asset lives that are currently too long and have historically been too long, so that LEC accounting profits are overstated relative to economic profits.[85]

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[84] AT&T, Appendix B.

[85] USTA Reply Comments, Attachment 4, National Economic Research Associates, Inc. (NERA Reply), p 34.

In addition, regulated earnings, and any "productivity" inferences derived from these earnings, are affected by numerous accounting conventions that have no impact on actual productivity achievements. A more detailed demonstration that changes in earnings are not the same as changes in achieved productivity is contained in Appendix ACCTEARN, attached hereto.

Second, as explained by NERA, AT&T's study contains an arithmetic error that significantly overstates AT&T's estimate of the productivity offset.[86] This and the conceptual errors in AT&T's approach invalidate AT&T's results. The Commission should reject AT&T's study as flawed.

In addition, AT&T and GSA analyze the earnings of an inappropriate subset of the price cap LECs.[87] Importantly, AT&T and GSA omitted GTE, the largest price cap LEC, from their analyses. AT&T claims that the reason GTE was omitted was because "it would have been extremely laborious to include them in this analysis."[88] SWBT suggests that the inclusion of GTE, for example, would have revealed fundamental flaws in the logic of AT&T's analysis. GTE is larger in terms of revenue subject to the Commission's price cap plan than any of the other price cap LECs. Application of AT&T's methodology to GTE data shows that AT&T's calculated productivity offset for GTE should have been lower than 3.3%. Thus, inclusion of GTE in AT&T's calculation would have revealed a basic flaw in AT&T's methods. In either

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[86] NERA shows that the average ROR represents the cumulative impact of two years' worth of productivity gains, not the single year gain implied by AT&T's analysis. As a result of this error alone, the productivity differential calculated using AT&T's flawed method is not only conceptually incorrect, but severely overstated. NERA, p. 38.

[87] AT&T, p.24; GSA, pp. 8-10, Attachments 1-4.

[88] AT&T, Appendix B, p. B-3.

the AT&T or the GSA analysis, inclusion of GTE would have reduced the productivity calculations.

b. MCI's Omission Of Data

MCI bases its support for a higher productivity offset on a "correction" of an allegedly inappropriate data point (1984) included in the short-term productivity study upon which the Commission relied, in part, in adopting the original productivity baseline estimate of 2.8%. MCI suggests that the Commission completely discard the experience of the entire LEC industry during the 1984/85 time period and claims that such a revisionist version of history would have resulted in a productivity factor of two percentage points higher than adopted by the Commission.[89]

Selectively excluding data from a single study is an improper basis for changing Commission policy on the appropriateness of the productivity offset. First, a significant number of productivity studies indicated that a productivity offset of approximately 2% would be an appropriate long-term objective for the price cap LECs. Removing a single data point from a single productivity study, as MCI proposes, should not justify a drastic increase in the productivity factor. Adoption of a 5.5% productivity offset would likely cause a massive flight of investment dollars from the LEC networks because the recommended incremental 3% to 4% reductions in prices and cash flow[90] would be imposed on the LECs at a time when competitive

[89] MCI, pp. 21-22.

[90] Because MCI underestimates the financial effect of the per-line common line recommendation, the true effect of MCI's recommended 5.5% productivity offset together with the per-line common line treatment is actually equivalent to a 6.6% productivity offset (using a balanced 50/50 common line price cap index formula). This would be an increase in the productivity offset of approximately 3.3 percentage points.

losses and increased investment risk will already be restraining the attractiveness of investment in the regulated portion of the telecommunications business.[91] Massively punitive regulatory provisions such as those recommended by MCI and AT&T are not in the public's best interest.

Second, the convergence of technology and providers in the telecommunications industry substantially increases the importance of relying on a broad examination of productivity trends and of determining long-term trends rather than short-term results. Because of this massive convergence, a broad examination of the long-term productivity trend is now even more important than in 1990 when the Commission ruled that the 1984/85 data was relevant. The Commission has already acknowledged that observed productivity can be very volatile in a single year or in a small number of individual years.

Selective focus on a short number of years, or selective exclusion of specific years that do not conform to preconceived arbitrary notions is wholly inappropriate. The Commission cannot accept: (1) MCI's suggestion that 1984/85 data be excluded; or (2) AT&T's suggestion that only 1991-93 data for a selected subset of price cap LECs be used for calculation of the long-term industry productivity trend. Adoption of such suggestions would handicap any serious efforts at examining productivity.

c. ETI's Study

In another attempt to contrive "evidence" that the current 3.3% productivity offset is too low, ETI cites the average total factor productivity (TFP) growth rate experienced in seven states over the 1984-91 period, and, after adding an input price differential and an "appropriate" stretch factor, suggests the price cap productivity offset should be increased to at

[91] See, Atlas in Forbes and Cauley in WSJ.

least 5.8%.[92] This proposal is flawed in several ways. First, as noted by NERA, ETI's estimated TFP growth rate of 3.8% is overstated as a result of a transcription error; corrected it is only 3.5%.[93]

Second, the ETI study includes data from only seven states located in only four price cap LECs' territories. Thus, ETI's study covers only a small number of the states, and, for example, excludes any evidence from SWBT, SNET, U S WEST or BellSouth. The productivity offsets from these few state incentive plans are not directly comparable because of the different structures and different mix of services of these plans. As such, the data likely are not representative of the industry as a whole. The Commission correctly recognized this:

> we do not believe that the designation of a 4.5 percent productivity offset factor for intrastate services in California should bear significantly on our selection of a productivity offset to be used in a federal price cap plan for interstate access since the plans differ in significant respects. Just as the productivity of one operating company cannot be assumed to apply to an entire segment of the telecommunications industry, the productivity offset for California cannot be assumed to apply to the Nation as a whole.[94]

Finally, the ETI study merely calculates the simple average of seven state TFP growth rates that were readily available, which may produce significantly different results than calculating an overall TFP measure from the aggregate measures of capital, labor, materials and output of the seven states. Basing an industry productivity offset on this erroneous, limited and

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[92] Ad Hoc, Attachment A, (ETI Paper).

[93] According to NERA, the TFP value for Delaware should have been recorded as 3.5% rather than 5.4% as shown on Table 6 of the ETI study. NERA Reply, p. 26.

[94] Policy and Rules Concerning Rates for Dominant Carriers, Supplemental Notice of Proposed Rulemaking, (FCC 90-89) released March 12, 1990, p. 53, fn. 191.